Capital Expenditure Incentive Guideline Review

Explanatory Statement - Final Guidelines

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AUSTRALIAN ENERGY REGULATOR

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1 Background

The Australian Energy Regulator (AER) exists to ensure energy consumers are better off, now and in the future. Consumers are at the heart of our work, and we focus on ensuring a secure, reliable, and affordable energy future for Australia as it transitions to net zero emissions. Our purpose is underpinned by our strategic objective to deliver efficient regulation of monopoly electricity and gas infrastructure while incentivising networks to become a platform for energy services.

Incentive schemes form an important part of our approach to regulating monopoly electricity and gas networks in Australia. We seek to incentivise network service providers (NSP) to run an efficient business so that customers pay no more than necessary for services that they value the most. The framework is designed to mimic the outcomes from effectively competitive markets.

The Australian Energy Market Commission's (AEMC) amending rule on *managing ISP project uncertainty through targeted ex post reviews* published in August 2024 (targeted ex post review rule change) enables us to carry out a targeted ex post review for individual Integrated System Plan (ISP) projects separately to a business' non-ISP capital expenditure (capex). In giving effect to this rule change, we must review and update our Capital Expenditure Incentive Guidelines (Guidelines) by 4 September 2025.

1.1 Existing incentive framework for capital expenditure

We use incentive-based regulation across all energy networks we regulate. Incentive-based regulation provides NSPs with financial incentives to improve their efficiency. This includes financial rewards where NSPs improve their efficiency and financial penalties where they become less efficient. Consumers benefit from improved efficiencies through lower regulated prices.

We apply incentive-based regulation through an approach known as the building block model. Under this approach, we set a total capex forecast based on what revenue we consider that an NSP requires to cover its efficient and prudent costs over a regulatory control period. Regulated prices are based on the building blocks and the forecast demand for the regulated services during a regulatory control period.

Under the building block model, we use to set regulated revenues, at the start of every regulatory control period we forecast the efficient and prudent capex that an NSP requires in that period. We add the forecast capex to the NSP's regulated asset base (RAB). In each year of the regulatory control period, regulated network prices are set based on a return on the undepreciated value of the RAB (return on capital building block), and the depreciated value of the RAB (return of capital building block).

Prior to the start of the next regulatory control period, we then adjust the RAB to account for any difference between forecast and actual capex during the current regulatory control period and depreciation. This is known as rolling forward the RAB. The new rolled forward RAB is then used as the basis for setting the return on capital and depreciation building blocks in the next regulatory control period. This process is repeated in each regulatory control period.

Under this approach, while we consider certain projects in determining our prudent and efficient total capex forecast, we do not determine which programs or projects an NSP should or should not undertake. Once we set a forecast, it is up to an NSP to prioritise its capex program within the total capex forecast given its circumstances, which are subject to change, over the course of the regulatory control period. In most circumstances, the NSP would have the flexibility to take mitigating actions, such as re-prioritising its capex, to ensure that its actual spend is within the allowance. Moreover, if an NSP has underspent against the capex forecast during a regulatory control period, an NSP will retain benefits of financing the forecast capex during the regulatory control period. This is the NSP's reward for making efficiency improvements. Consumers will then benefit after the end of the period when the RAB is rolled forward to a lower amount than if the full amount of the capex forecast had been spent. This leads to lower regulated network prices into the future.

The ex ante and ex post measures, such as the Capital Expenditure Sharing Scheme (CESS) and ex post review process, outlined in the Guideline complement this existing incentive an NSP has to deliver efficient capex. These are explained below.

1.2 The AER's Capital Expenditure Incentive Guidelines

The Guidelines outline the ex ante and ex post measures to incentivise prudent and efficient capex. Capex refers to the money required to build, maintain or improve the physical assets needed to provide services. Generally, these assets have long lives, and an NSP will recover capex from customers over several regulatory control periods through network tariffs.

The CESS and the use of forecast depreciation on capex are ex ante measures that provide up front incentives for NSPs to pursue efficient capex. These ex ante measures are complemented by our ex post review, which allows us to assess the efficiency and prudency of capex after it is incurred. This helps to ensure we only use efficient and prudent capex to set regulated prices.

Taken together, the CESS and ex post review outlined in the Guidelines should contribute to achieving the capital expenditure incentive objective under clauses 6.4A and 6A.5A of the NER:

> *The capital expenditure incentive objective is to ensure that, where the value of a regulatory asset base is subject to adjustment in accordance with the Rules, then the only capital expenditure that is included in an adjustment that increase the value of that regulatory asset base is capital expenditure that reasonably reflects the capital expenditure criteria.*[1]

In particular, the CESS provides NSPs with incentives to pursue efficiency gains throughout the regulatory control period. NSPs will have a constant incentive to reduce capex irrespective of the year of the regulatory control period and whether they have overspent or underspent in total. It achieves this by rewarding NSPs that outperform their approved capex

[1] The capex criteria require we be satisfied that forecast capex reflects prudent and efficient costs and a realistic forecast of demand and cost inputs and other relevant inputs. See National Electricity Rules ('NER'), clause 6A.6.7(c)(1)-(3) and clause 6.5.7(c)(1)-(3).

forecast and penalising NSPs that spend more than their approved capex forecast on a consistent basis in each year of the regulatory control period. The CESS also provides a mechanism to share efficiency gains and losses between NSPs and consumers. For clarity efficient gains and losses refers to how efficient the NSP has been with its spending against its forecast capex (that is whether the NSP has spent more or less than the efficient levels of forecast capex that we have set for the relevant regulatory control period). We note that in most circumstances, the NSP would have the flexibility to take mitigating actions, such as re-prioritising its capex, to ensure that its actual spend is within the allowance. But, if an NSP overspent its forecast capex, then we will undertake an ex post review.

The ex post measures complement the CESS to provide NSPs with an additional incentive to ensure that any overspends are efficient and prudent, relative to the capex criteria. Under the current CESS, NSPs bear 30% of the cost of an overspend above the set forecast capex. If the overspend is found to be imprudent and inefficient relative to the capex criteria, however, the NSP will bear 100% of the imprudent and inefficient overspend. In addition, we also may exclude inefficient related party margins and capitalised operating expenditure (opex) that does not benefit consumers.

We consider this approach is consistent with the NER because the CESS measures the size of the improvements or declines in efficiency against the relevant forecast capex. However, in an event an NSP overspent its forecast capex, we assess whether the overspent capex meets the capex criteria. Only the portion we are satisfied to meet the capex criteria is rolled forward in to the RAB. These two approaches taken together to ensure there is a credible pathway for the NSP, acting in a reasonable manner, to recover its costs, while incentive networks to operate within it forecast capex. These measures are intended to work in a way so that consumers pay only for efficient and prudent overspends and share in the benefits where an NSP is able to spend less than its capex forecast.

These measures also complement the incentive schemes for opex (Efficiency Benefit Sharing Scheme) and for service standards (Service Target Performance Incentive Schemes) and are designed to balance the incentives to reduce expenditure against maintaining service standards.

1.3 Scope of this review

This Guidelines review considered the statutory amendments made by the AEMC's targeted ex post reviews rule change and additional matters that has been raised by stakeholders since our 2023 review of incentive schemes for regulated networks (2023 Incentives Review).[2]

We have received a number of regulatory proposals requesting exclusions for the CESS, including from the Victorian distribution network service providers (DNSPs) for the 2026-31 regulatory period. The current Guidelines (version 3) do not allow for any exclusions for DNSPs.[3]

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[2] Australian Energy Regulator ('AER'), *Review of incentive schemes for regulated networks: Final Decision*, 28 April 2023.

[3] For transmission network service providers (TNSP), we may vary the application of the CESS to allow for exclusions in contingent project assessments.

NSPs state that there are a range of specific and new forecasting errors arising due to the energy transition. They contend that the current CESS approach will result in projects being inefficiently deferred or NSPs bearing the forecasting risk and likely being penalised via the CESS for efficient expenditure. NSPs consider this forecasting risk can be managed via ex ante CESS exclusions.

Against this context, this review considered:

- how we should undertake the separate targeted ex post reviews for ISP project capex and non-ISP project capex
- what factors we will take into account to conclude whether an actionable ISP project, or a stage of an actionable ISP project, is substantially complete
- how we would apply the CESS to reviewable ISP projects that span across multiple regulatory control periods
- whether we should allow certain categories to be excluded from application of the CESS to accommodate the uncertainties in forecasting
- whether we should reduce the CESS penalties incurred on an ex post basis
- how we should apply the CESS to projects that are efficiently abandoned.

1.4 Consultation process

We published our draft Guidelines and the accompanying explanatory statement on 16 May 2025, and received 16 submissions from NSPs, retailers, consumer groups and an individual consumer.

The final Guidelines (version 4) and this explanatory statement incorporate feedback from the written submissions we received in response to our draft Guidelines and the accompanying explanatory statement.

1.5 Structure of this explanatory statement

This explanatory statement is structured as follows:

- Chapter 2 discusses our method for undertaking separate targeted ex post reviews for ISP project capex and non-ISP project capex
- Chapter 3 sets out the factors we will take into account to conclude whether an actionable ISP project, or a stage of an actionable ISP project, is substantially complete
- Chapter 4 discusses how we will modify the CESS to ensure a transmission network service provider (TNSP) is not being penalised more than 100% of overspend expenditure that is found to be inefficient following an ex post review on a reviewable ISP project spanning across multiple regulatory periods
- Chapter 5 discusses ex ante and ex post CESS exclusions, including CESS exclusions for ISP projects
- Chapter 6 discusses the interactions between the CESS and efficiently abandoned ISP project
- Chapter 7 discusses matters in relation to the transitional provision, and the application of the CESS for renewable energy zone (REZ) projects and businesses with single asset regulatory asset base

- Appendix A provides illustrative examples on how we will consider the CESS exclusions.

2 Separate targeted ex post review of ISP projects and non-ISP projects

2.1 Issue

The amendments to the National Electricity Rules (NER) will establish separate targeted ex post reviews for ISP project capex and non-ISP project capex.[4] This is a departure from the current Guidelines (version 3) where we undertake an ex post review of total capex rather than individual capex projects.

In giving effect to the rule change we are required to define how we would undertake the separate targeted ex post reviews of ISP project capex and non-ISP project capex.

In the draft Guidelines we proposed to extend the current 2 stage ex post review process to also apply to ISP projects.

2.2 Amendments

Changes from the draft Guidelines

- There have been no changes from the draft Guidelines to this issue. We will apply the existing 2 stage ex post review process for ISP projects. Please see our justification noted in section 2.4 below.

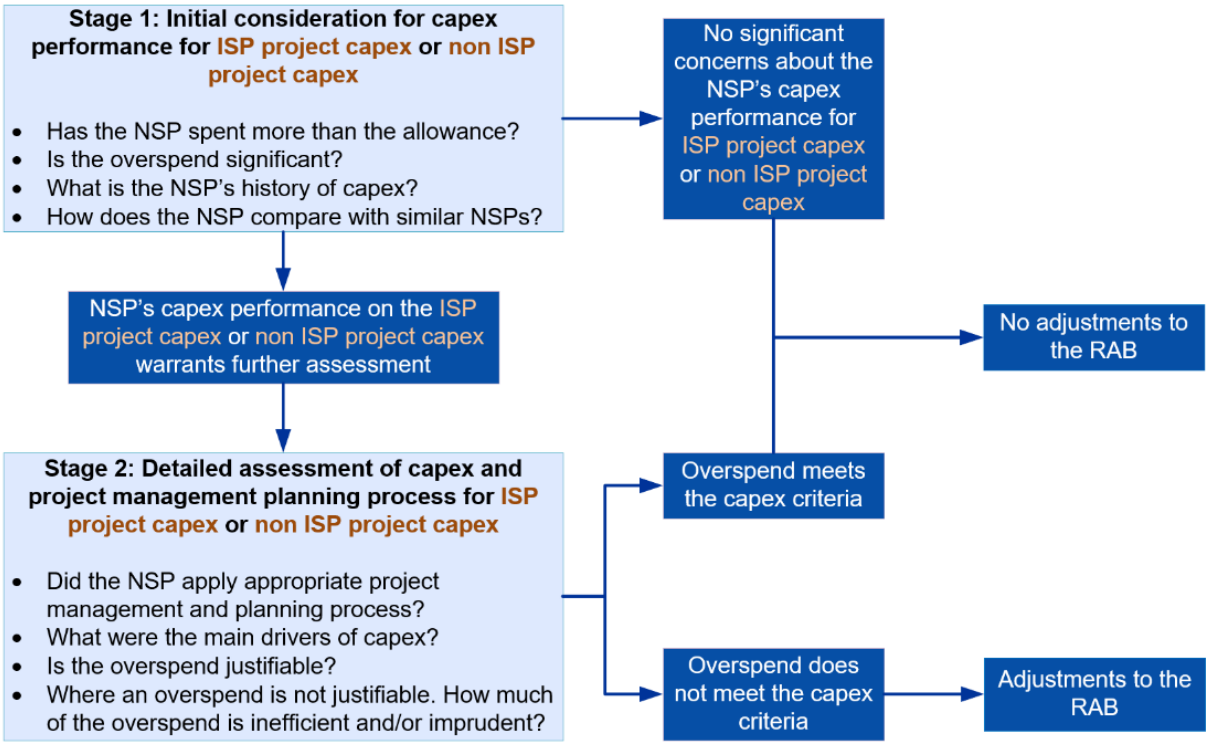
We have maintained our draft Guidelines approach. In the draft Guidelines we proposed to make minor amendments to the ex post review process consistent with the AEMC's position.[5]

We have amended the Guidelines to apply our current ex post review approach to ISP project capex and non-ISP capex separately, rather than a single ex post review on total capex. The figure below illustrates the 2 stage process we will undertake for ex post reviews. In stage 1 we will assess the NSP's actual capex performance and in stage 2 we will undertake a detailed assessment. In undertaking our assessment, we will have regard to the factors listed in Figure 1 below. The factors listed in the diagram are not exhaustive. Please see section 4.3 of the final Guidelines (version 4).

4 NER cl. S6A2.2A(f).

5 Australian Energy Market Commission ('AEMC'), *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, pp. 14-16.

Figure 1: Separate targeted ex post reviews



2.3 Stakeholder views

We received a range of views from stakeholders to our draft Guidelines:

- Transgrid submitted that while it supports the proposed approach to separately apply ex post reviews to ISP and non-ISP projects, it seeks further guidance from the AER on its approach to assessing prudency and efficiency for actionable ISP projects[6]
- EnergyAustralia submitted that there is a need to further scrutinise the ongoing costs of ISP projects to better protect consumers – specifically, it stated that the AER should set clear expectations by considering the following:[7]
  - the standard of project management, procurement, supply contracting and planning processes adopted
  - the extent to which projects had already been subjected to several upward revisions in costs during their RIT-T assessment and the contingent project application processes
  - how to treat instances of cost increases arising due to supply bottlenecks
  - the extent of any scope creep and poor decision making or timing of decisions that has led to cost overruns
  - benchmarking across network businesses in how these risks have been managed in their jurisdiction and in project execution

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6 Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 12-13.

7 Energy Australia, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-4.

- broader questions of risk allocation and treatment of contingencies
- whether cost thresholds should apply that warrant different approaches by the AER in undertaking assessments, including intervention ahead of project completion
- efficient project abandonment as "Actionable" should not mean they be executed at any cost and as fast as possible
- transparency for stakeholders.

2.4 Reasons for our positions

Our existing two-stage approach for ex post reviews is sufficiently flexible and fit for purpose for both ISP and non-ISP capex to be applied separately. This approach allows us to determine what level of analysis and examination is required on a case-by-case basis.

Stage 1 of our ex post review process considers whether the overspend is significant at the total cumulative forecast capex level for ISP project capex and non-ISP project capex respectively. If the NSP's cumulative capex overspend warrants further assessment, then we undertake stage 2. Stage 2 involves a detailed assessment of the drivers of the NSP's capex and the NSP's management and planning tools and practices. We will undertake this approach for ISP project capex and non-ISP project capex separately.

We received limited stakeholder submissions on this issue. Transgrid sought further guidance on how will assess prudency and efficiency for actionable ISP projects.[8] EnergyAustralia considered that there is a need to further scrutinise the ongoing costs of ISP projects to better protect consumers.[9]

Section 4.3 of the current Guidelines (version 3) set out the principles and manner in which we will undertake ex post assessments. This guidance is sufficiently flexible to apply to ISP projects on a case-by-case basis. As shown in Figure 1 above, our Guidelines lists out certain questions we may consider in our ex post review assessment. These questions are not intended to be an exhaustive list but rather guiding principles that can be applied to any project, including ISP projects.

For instance, in considering "*what is the history of capex*", we may assess the extent of any regulatory investment test (RIT) revisions made for that specific project, any risk and contingency cost allowance for the specific project, and any scope amendments that were not included in the forecast. Similarly, the question "*what were the main drivers of capex*" allows us to assess if cost increases by NSPs were due to poor decision making or timing of decisions. This includes how well NSPs have managed their delivery and procurement risk profile, the balance of work outsourced or completed in-house, and how they have maintained or maximised competitive tensions.

We also note that EnergyAustralia has queried whether cost thresholds should apply that warrant different approaches by the AER in undertaking assessments.[10] We are concerned

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8 Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 12-13.

9 EnergyAustralia, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-4.

10 EnergyAustralia, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-4.

that prescription of specific threshold may lead to sub-optimal outcomes for consumers. While a threshold could provide greater transparency and consistency in assessing different NSPs' capex overspends, it could create a new 'target' for NSPs. There may also be negative outcomes if we cannot undertake a detailed review of inefficient overspends below the threshold. It is also difficult to derive and justify an appropriate threshold that works for all NSPs. For these reasons, we do not consider it is appropriate to specify a particular threshold.

Finally, we consider ex post reviews to be a critical component in ensuring ISP project capex meets the capital expenditure incentive objective. The ex post review process is a key stage in identifying whether the capex to be rolled into the RAB is efficient and works in conjunction with the ex ante incentives.

Therefore, our two-stage approach allows us to assess information from NSPs and scrutinise any overspend expenditure based on the merits of the circumstances.

3 Factors for establishing that an ISP project is substantially complete

3.1 Issue

The AEMC's rule change introduced the terms "ISP project review period" and "reviewable ISP project". Once a project has been substantially completed, it becomes a "reviewable ISP project" in which the AER can undertake an ex post review over the period in which the actionable ISP project, or a stage of the actionable ISP project, was constructed.[11] The ISP project review period encompasses the whole period in which a TNSP has incurred capex on the actionable ISP project, or a stage of the actionable ISP project.[12]

We consider that a reviewable ISP project stage includes any predefined stage of an actionable ISP project other than early works stage.

In our draft Guidelines, we consider that TNSPs should put forward a proposal that seeks to demonstrate that the actionable ISP project, or stage of an actionable ISP project, is substantially complete by reference to the following factors:

i) Whether the completed works and costs incurred on the actionable ISP project, or stage of an actionable ISP project are a sufficient representation of the likely overall capex outcome. For example, if the substantially complete project is expected to not meet the overspending requirement, is this still likely to be the case once the whole project is completed?

ii) Whether the TNSP expects to incur additional construction costs related to the actionable ISP project, or a stage of an actionable ISP project, or whether the only remaining works are associated with commissioning and energising the assets for the relevant actionable ISP project, or stage of an actionable ISP project.

iii) Whether the estimated future capex of the remaining works for the relevant actionable ISP project, or stage of an actionable ISP project, and any cost variations, will be immaterial (as assessed by the AER on a case by case basis).

iv) Whether the remaining works are expected to be completed, and the costs expected to be incurred, before the AER has completed its final determination.

[11] NER clause S6A.2.2A(a1); AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination*, 01 August 2024, pp. 14-16.

[12] We note that TNSPs have the ability to define project stages for a large network project.

3.2 Amendments

Changes from the draft Guidelines

- We have made minor clarifications to our final Guidelines (version 4) to improve clarity, but these changes from our draft Guidelines do not otherwise alter the requirements or considerations.

We have maintained our draft Guidelines approach. In the draft Guidelines, we introduced a new sub section 4.3.4 referring to ex post reviews for ISP projects. The TNSP bears the onus to propose that an actionable ISP project, or a stage of an actionable ISP project, is substantially complete and hence eligible for a targeted ex post review. [13] In putting forward a proposal, TNSPs should seek to demonstrate that the project, or project stage, is substantially complete by reference to the factors mentioned above.

However, in an event where a TNSP incurs materially higher capex after a project is substantially complete, the AER reserves the right to reassess the ex post review. Please see section 4.3.4 of the final Guidelines (version 4).

3.3 Stakeholder views

ENA and Transgrid broadly support the approach we proposed in the draft Guidelines.[14] ENA submitted that we should clarify in the final Guidelines (version 4) that the NSPs will be responsible for proposing whether an actionable ISP project, or stage of an actionable ISP project, is substantially complete.[15]

Ausgrid stated that we should adopt a more flexible approach than apply a rigid, restrictive and mandatory checklist.[16] It considered that by focusing on the substantive completion and de-risking of the project, would better achieve the AEMC's objective of providing timely regulatory assessment, rather than a rigid, checklist-based approach that could be held up by minor, non-material outstanding works.[17]

ENA and Ausgrid stated that ISP projects may be undertaken by DNSPs, including in accordance with *Electricity Infrastructure Investment Act 2020 (NSW)* (EII Act), and therefore considered that we should amend the Guidelines to refer to NSPs rather than TNSPs.[18]

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[13] Any predefined stage of a staged ISP project other than early works stage.

[14] Energy Networks Australia, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 8-9; Transgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 12-13.

[15] Energy Networks Australia ('ENA'), *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 8-9.

[16] Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 6-7.

[17] Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 6-7

[18] ENA, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2; Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 6.

3.4 Reasons for our positions

In the final Guidelines (version 4) we included additional wording to clarify that the NSP should seek to put forward a case as to why an ISP project is substantially completed, having regard to the factors.

Consistent with the propose-respond model under the NER, we consider that it is appropriate for a TNSP to put forward a case as to why an ISP project is substantially completed, having regard to the factors set out above. Then, at the time of our draft regulatory determination, we will make a decision as to whether we consider that an actionable ISP project, or a stage of an actionable ISP project, is substantially complete, having regard to those factors.

We note that stakeholders were broadly supportive of our approach. However, we acknowledge that Ausgrid sought more flexibility.

As per our justification in the draft Guidelines, we maintain our view that the factors provide sufficient flexibility to TNSPs, as the factors allow us to assess a project before its completion. For instance, the wording of factor (i) refers to the costs incurred being a "sufficient representation of the likely overall capex outcome" and factor (iii) refers to expected future costs being "immaterial" and the threshold for this being determined on a case-by-case basis. As ISP projects begin passing through the updated ex post review process, we anticipate a common understanding of our approach will develop between the AER, NSPs and other stakeholders.

The purpose of the ex post review is to determine whether any imprudent and inefficient expenditure has been incurred. To align with the intent of ex post reviews, we consider it is necessary to take into account whether there are any remaining construction costs and the timeframe in which the remaining costs are expected to be incurred. Outstanding physical construction costs suggest the project is not close to completion by the end of the relevant regulatory period and may have a greater risk of unexpected overruns. Therefore, allowing greater flexibility with timeframes or allowing remaining construction costs may introduce unnecessary risk that the outstanding project costs may change from what is expected to be immaterial.

Furthermore, we consider the term reviewable ISP project, that will be introduced to the NER, only relates to TNSPs. This is because a reviewable ISP project is defined as an 'actionable ISP project', or a 'stage of an actionable ISP project' that has been substantially completed within a review period. The term "actionable ISP project" in the Rules only relates to transmission assets and non-network options, rather than distribution assets,[19] Further, the term "reviewable ISP project" will only be used in the Rules in the transmission context.[20] For these reasons, we are not amending the Guidelines to refer to NSPs rather than TNSPs.[21]

[19] NER, Chapter 10.

[20] NER, cl. S6A.2.2A(a1)

[21] In relation to REZ projects, the jurisdictional REZ framework will apply.

4 Modification to the CESS to accommodate multi-period ISP projects

4.1 Issue

In relation to reviewable ISP projects that span across multiple regulatory periods, we are considering how we can ensure that a TNSP does not face a penalty above 100% for an inefficient overspend.

The current Guidelines (version 3) includes a mechanism to reverse any CESS penalty for capex that is subsequently found to be inefficient as part of an ex post review. This means that an NSP does not face a penalty above 100% of the inefficient overspend. However, this mechanism is limited to a 5 year ex post review period.

In the draft Guidelines, we proposed to allow ourselves the flexibility to adjust the CESS penalties for reviewable ISP project capex incurred during the ISP project review period that is later found to be inefficient and excluded from the RAB as part of an ex post review.

4.2 Amendments and reasons for our positions

Changes from the draft Guidelines

- There have been no changes from the draft Guidelines to this issue.

We maintained our draft Guidelines approach. Our final Guidelines (version 4) adopts the current mechanism to reverse any CESS penalty for a reviewable ISP project capex that is subsequently found to be inefficient as part of an ex post review. We do this by introducing a new sub section to 2.8, which explicitly allows us to adjust the CESS penalties for ISP capex incurred during the ISP project review period that is later excluded from the RAB as part of an ex post review.

We will extend this mechanism to apply for the whole ISP project review period (period in which capex was incurred in relation to an actionable ISP project, or a stage of an actionable ISP project, that is substantially completed).

Please see section 2.8.3 and section 4.4 of the final Guidelines (version 4).

All stakeholder submissions we received on this issue supported our proposed approach in the draft Guidelines.[22] That is to reverse or adjust CESS penalties for inefficient capex from projects that span multiple regulatory periods and refunding penalties when capex is excluded from the RAB following an ex post review, taking the time value of money into account.

[22] ENA, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 8; Transgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 13.

5 Exclusions from the application of the CESS

5.1 Issue

The current Guidelines (version 3) do not allow for general exclusions from the application of the CESS. However, for TNSPs, we may vary the application of the CESS for transmission contingent project proposals. [23] This allows for a bespoke CESS to be applied to transmission contingent projects including ISP projects.

In this Guidelines review process, we sought stakeholder views on two types of changes to the CESS:

- whether there is a need to modify the application of the CESS generally, to allow CESS exclusions on certain capex categories on an ex ante basis, and
- whether we should have the flexibility to adjust the application of the CESS after an ex post review.

Ex ante CESS exclusions enable certain capex to be excluded from the CESS calculation as identified at the time of when the AER makes its regulatory determination. The excluded capex is identified ahead of time before an NSP undertakes the capex. In practice, the excluded capex is removed from the forecast and the actual capex incurred when calculating a network's efficiency gain or losses. Therefore, a network will not receive a CESS reward or penalty for the excluded capex. However, the network will retain the financing benefit or cost they would receive within the period from the time value of money.

Ex post adjustments to the application of the CESS allows us to reduce an NSP's CESS penalties where we consider it is not reasonable to incur a such a penalty on the relevant overspend.[24] This allows us to vary the application of the CESS on retrospective basis if an NSP overspent its forecast capex following an ex post review. In the event of an underspend over the ex post review period, there would be no ex post adjustment.

In the draft Guidelines we introduced CESS exclusions in a targeted way to address some forecasting uncertainties. Specifically, we introduced:

- ex ante CESS exclusions for DNSPs' connection capex for its business-as-usual connections via volumetric adjustment
- discretion for us to adjust CESS penalties following an ex post review in relating to DNSPs' large bespoke connections capex
- discretion for us to adjust CESS penalties, using a set of factors, following an ex post review relating to TNSP's ISP project capex and non-ISP project capex.

[23] For TNSPs, any capex incurred under the network capability component of the STPIS is not included in the capex calculation.

[24] The Guidelines already allows for CESS adjustments for capex that is found to be inefficient.

5.2 Amendments

Changes from the draft Guidelines

- We have made amendments to the Guidelines to increase clarity and provide certainty, but these changes, from our draft Guidelines, do not otherwise alter the requirements or considerations. The change from the draft Guidelines is set out below.
- We have included the definition of business-as-usual connection types, to clarify to which connection types we may apply volumetric adjustments for DNSPs' connection capex.
- For DNSPs' large bespoke connection capex, we have included the definition of large bespoke connections and clarified that ex post CESS adjustments are applied to net capex.
- In relations to ex post CESS exclusions for TNSP's non-ISP project capex, we have replaced the factor "a comparison of the projects undertaken against projects forecasted for the relevant regulatory determination" with "whether the proposed adjustments relate to projects that were not included in the TNSP's forecast" for clarity.
- We have amended section 2.3.4 to allow an NSP to propose variations in its CESS payment to voluntarily reduce its CESS reward, or increase its CESS penalty, as it may directly benefit consumers.

Our Guidelines changes for ex post and ex ante CESS exclusions are set out in Table 1.

Table 1: Final amendments to specific sections in the Guidelines (version 4)

Network	Exclusion Mechanism	Details
DNSP	Ex ante exclusion	We have amended section 2.6 of the Guidelines to accommodate ex ante exclusions for DNSPs for connections capex. This exclusion mechanism applies a volumetric adjustment to a DNSP's business-as-usual connections capex (excluding bespoke/emerging connection types). A volumetric adjustment is a symmetrical mechanism that takes into account changes in volume so that a network is not rewarded or penalised for changes in the volume of work they need to undertake. No other types of capex can be excluded on an ex ante basis. Please see section 2.6.1 of the Guidelines (version 4).
DNSP	Ex post exclusion	We have amended section 2.8 in the Guidelines to introduce a new sub section allowing CESS adjustments following an ex post review. This effectively introduces a mechanism to allow ex post CESS exclusions for large bespoke connection capex that has not been included in DNSP's forecast capex.

Network	Exclusion Mechanism	Details
		Please see section 2.8.1 of the Guidelines (version 4).
TNSP (non-ISP project capex)	Ex post exclusion	We have amended section 2.8 in the Guidelines to introduce a new sub section allowing CESS adjustments following an ex post review. This effectively introduces a mechanism to allow ex post CESS exclusions. This mechanism applies where there is an efficient increase in an NSP's scope of works, and the incurred capex is not accounted for in a contingent project application, cost pass through application or a reopener. We will only consider allowing ex post exclusions in limited circumstances at our discretion based on the following factors: • whether the proposed adjustments relate to projects that were not included in the TNSP's forecast • our findings in the relevant ex post review period • whether the TNSP has demonstrated it has reasonably managed and prioritised its capex • the degree to which the overspend was due to factors beyond the TNSP's control • other relevant factors Our default position is to apply the CESS without any ex post exclusions. Please see section 2.8.1 of the Guidelines (version 4).
TNSP (ISP project capex) (These changes also relate to REZ and businesses with single asset RAB)	Ex post exclusion	We have amended section 2.8 to allow flexibility for us to reduce CESS penalties following an ex post review for reviewable ISP projects.[25] In deciding whether to exercise this flexibility, we will have regard to the following factors: • the form of CESS in place for the relevant reviewable project • our findings in the relevant ex post review period • whether the NSP has demonstrated it has reasonably managed and prioritised its capex • the degree to which the overspend was due to factors beyond the NSP's control • other relevant factors. Please see section 2.8.3 of the Guidelines (version 4).

[25] As discussed below, we may also consider ex post CESS adjustments for other CESS decisions including but not limited to NSW REZ non-contestable determinations delivered under the EII Act, and businesses with a single asset RAB.

Network	Exclusion Mechanism	Details
DNSP & TNSP	-	We have amended section 2.3.4 to allow an NSP to propose variations in its CESS payment to voluntarily reduce its CESS reward, or increase its CESS penalty, as it may directly benefit consumers. Please see section 2.3.4 of the Guidelines (version 4)

5.3 Stakeholder views

Stakeholders set out a range of views in response to our draft Guidelines on the issue of CESS exclusions. We have grouped the submissions into the relevant topics.

5.3.1 CESS exclusions for DNSP's capex

This sub-section summarises the submissions relating to CESS exclusions for DNSPs.

In relation to ex ante CESS exclusions, ENA and DNSPs considered that:

- volumetric adjustment may be impractical to be applied and therefore we should allow DNSPs to propose ex ante exclusions for all connections capex[26]
- volumetric adjustment should not be applied as a default but rather allow DNSPs to propose volumetric adjustment or other approaches to addressing forecasting risk[27]
- the proposed method does not account for variances in the size and cost of differing types of connections so we should set methodologies for how we intend to apply for ex ante volumetric exclusions[28]

[26] Evoenergy, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2; Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 5; Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Endeavour Energy, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; South Australia Power Network ('SAPN'), *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; ENA, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 7.

[27] ENA, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 6-7; Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 7; SAPN, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Energy Queensland, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Evoenergy, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 7-8; Endeavour, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[28] Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 7-8; ENA, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 6-7; Endeavour, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Energy Queensland, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3.

- the adjustment does not account for the impact of capital contributions or differences in connection policies[29]
- we should clarify the definition of 'standard connection' as this has a different meaning under NER 5A.A.1 Definitions.[30]

For large bespoke connections, ENA and DNSPs considered that:

- the AER's discretion reduces certainty and may impact investment decisions[31]
- ex post exclusions may produce misaligned outcomes due to the higher amount of capital contributions[32]
- we should allow an ex ante exclusion for bespoke connections based on pre-defined criteria[33]

For the reasons above, DNSPs stated that we should exclude connections capex (either a proportion or the entire connections capex) from the CESS because forecasting uncertainty is not limited to just connection volumes but also costs.[34] Jemena considered this approach would reduce the regulatory burden required in assessing how the allowance for different types of connections was set and how the actual capex was incurred.[35]

Some DNSPs also considered we should allow broader exclusions for expenditure incurred due to factors beyond an NSPs control, such as supply chain issues, increase in material

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[29] ENA, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 6-7; Jemena, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Energy Queensland, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 1; SAPN, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 3.

[30] Evoenergy, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Energy Queensland, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Jemena, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[31] ENA, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 7; CitiPower, Powercor and United Energy ('CPU'), *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 3-6.

[32] Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-5; Jemena, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 3-5,

[33] Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-5; AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025*,* pp. 3-5; Energy Queensland, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-3.

[34] CPU, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 1. Jemena, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Ausgrid, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-5; Energy Queensland, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[35] Jemena, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

costs and volatile market conditions/ general economic activity.[36] These DNSPs considered that we should allow flexibility to propose exclusions based on pre-defined ex ante criteria.[37]

DNSPs do not consider it appropriate for the AER to reduce CESS rewards if they underspend their forecast capex. They stated that such an approach would imply a level of forensic scrutiny into NSPs investment decision processes, which is contrary to good regulatory practice.[38]

The Energy Users Association of Australia ('EUAA') and Save Our Surrounding Riverina considered that NSPs should bear the onus to manage any cost overruns, and these costs should not be passed on to consumers.[39] EUAA also considered that exclusions or reductions in CESS penalties removes the onus on the NSP to take all due care in managing a project to minimise overspends.

In addition, we also had regard to Victorian Department of Energy, Environment and Climate Action's ('DEECA') submission to the issues paper on the draft proposals for each of the Victorian electricity DNSPs for the 2026-31 regulatory control period.[40] DEECA stated that it finds no reason as to why NSPs cannot accurately forecast connections.[41] DEECA considered that exclusions may lead to NSPs not carrying out connections more efficiently and the AER should ensure overinvestment is disincentivised and the overall benefit is to consumers.[42]

5.3.2 CESS exclusions for TNSP's ISP project capex and non-ISP project capex

This sub-section summarises the submissions relating to CESS exclusions for TNSPs ISP and non-ISP project capex.

In relation to CESS exclusions for ISP project capex, ENA and TNSPs submitted that:

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[36] SAPN, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Energy Queensland, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 3.

[37] SAPN, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[38] CPU, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; ENA, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 7-8; Jemena, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 4; Evoenergy, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; SAPN, *Submission to AER Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 4.

[39] Energy Users Association Australia ('EUAA'), *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2; Save Our Surrounding Riverina, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025.

[40] Department of Energy Environment and Climate Action ('DEECA'), *Submission to the AER's Issues Paper on the draft proposals for each Victorian electricity DNSP for 2026-31 regulatory control period*, 3 June 2025, pp. 8-9 [49]-[52].

[41] DEECA, *Submission to the AER's Issues Paper on the draft proposals for each Victorian electricity DNSP for 2026-31 regulatory control period*, 3 June 2025, pp. 8-9 [50].

[42] DEECA, *Submission to the AER's Issues Paper on the draft proposals for each Victorian electricity DNSP for 2026-31 regulatory control period*, 3 June 2025, pp. 8-9 [51].

- if expenditure is found to be prudent and efficient following an ex post review, we should not penalise NSPs under the CESS framework[43]
- the CESS should only apply up to a certain extent, such as 10% of overspends, and then only ex post review should apply[44]
- the AER's discretion reduces certainty and may impact investment decisions[45]

For non-ISP projects, ENA and TNSPs are supportive, in principle, for the CESS exclusions being awarded if there is a material increase in a TNSP's scope of works.[46] But they do not agree with the AER having broad discretion in determining whether to apply any adjustments and considered that we should consider CESS exclusions for overspends due to external factors such as supply chain issues.[47] Furthermore, similar to the comments above, some TNSPs also considered that if expenditure is found to be prudent and efficient following an ex post review, we should not penalise NSPs under the CESS framework.[48]

TNSPs also do not consider it appropriate for the AER to reduce CESS rewards if they underspend their forecast capex. They stated that such an approach would imply a level of forensic scrutiny into NSPs investment decision processes, which is contrary to good regulatory practice.[49]

As noted above, non-network stakeholders do not consider we should allow exclusions from the CESS.[50] EUAA also raised concern over the AER having discretion to allow any

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[43] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-6; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2; Marinus Link Pty Ltd (MLPL), *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 9-12.

[44] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 5; MLPL, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 9-12.

[45] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 6; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 9-12.

[46] Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2.

[47] Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 9; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 6.

[48] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 6; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 13; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 1.

[49] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 7-8; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 13-14.

[50] See section 5.3.1.

modification of the CESS sharing ratio or exclusions.[51] It considered that consumers require certainty as to the application of the CESS.[52]

5.4 Reasons for our positions

The NER establish ex ante incentive-based regulation. There are two key elements to how we implement incentive-based regulation: the setting of expenditure forecasts and the incentives an NSP faces to beat these forecasts. The CESS framework provides NSPs the ex ante financial incentives to improve their efficiency.

We consider any changes to the CESS framework should retain the fundamental purpose of the ex ante incentives. This includes establishing financial rewards where NSPs improve their efficiency and financial penalties where they become less efficient. This approach encourages NSPs to seek the most efficient solution when deciding whether to incur the expenditure. Consumers benefit from improved efficiencies through lower regulated prices, also known as network tariffs.

The current incentive based framework is robust and fit for purpose. However, we recognise that there have been changes in the operating environment since the CESS was introduced. In addressing this, in our draft Guidelines, we proposed some amendments to the CESS in a targeted way. These changes retain the financial incentives for NSPs to ensure outcomes for consumers consistent with the National Energy Objectives but also address NSPs' concerns. We also maintained our approach for limited interventions to the ex ante framework.

The suggested amendments raised in several NSP submissions to our draft Guidelines would fundamentally change the operation of the CESS if implemented. In these submissions we identified three overarching themes:

1. whether the current operation of the CESS is unfairly penalising forecasting uncertainties
2. whether the operation of the CESS and ex post review is consistent with the NER and the NEL
3. the level of discretion to adjust CESS payments following an ex post review.

Overall, we are careful not to introduce too many changes to the CESS as it could result in unintended consequences. We also do not consider that it is appropriate or desirable to change the fundamental operation of the CESS and the ex ante incentive regime. Consistent with our draft Guideline approach, it is more appropriate to make specific adjustments to the material issues that broadly maintain the fundamental operation of the CESS.

We have discussed these three themes in turn below.

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[51] EUAA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[52] EUAA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

5.4.1 Forecasting uncertainties

NSPs have raised concerns that some areas of capex may have higher forecasting error than others and did not consider it is reasonable for the CESS to penalise forecasting error.[53]

Meanwhile non-NSP related submissions identified concerns that adding exclusions would decrease the incentive for NSPs to undertake efficient capex.[54] These submissions considered that NSPs should bear the onus to manage any cost overruns, and these costs should not be passed on to the consumers.[55]

We acknowledge that under an ex ante framework, CESS rewards and penalties may include an element of forecast error. Adjusting the CESS to account for forecast error would reduce the power of our incentive based regulatory framework.

We consider the updated CESS framework is balanced as it provides sufficient incentives to undertake efficient capex. The updated Guidelines continues to incentivise NSPs to underspend against their approved forecast. However, we have also recognised there are elements where forecasting uncertainties have the potential to disproportionately drive incentive payments. This is why we have limited potential to make adjustments to the CESS where we consider there is significant forecast uncertainties and accounts for factors beyond the control of the NSP.

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[53] See generally Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Endeavour, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Evoevergy, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; MLPL, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025.

[54] See generally Save Our Surrounding Riverina, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; EUAA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; DECCA, *Submission to the AER's Issues Paper on the draft proposals for each Victorian electricity DNSP for 2026-31 regulatory control period*, 3 June 2025, pp. 8-9.

[55] See generally Save Our Surrounding Riverina, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; EUAA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; DECCA, *Submission to the AER's Issues Paper on the draft proposals for each Victorian electricity DNSP for 2026-31 regulatory control period*, 3 June 2025, pp. 8-9.

5.4.2 Operation of the CESS and the ex post review

NSPs submitted that, if expenditure is found to be prudent and efficient following an ex post review, we should not penalise NSPs under the CESS framework.[56] Specifically, these NSPs considered applying a financial penalty to efficient capital expenditure cannot be consistent with the CESS principles set out in clause 6A.6.5A(c)(2) [and 6.5.8(c)(2)]:[57]

> *"the rewards and penalties should be commensurate with the efficiencies or inefficiencies in capital expenditure, but a reward for efficient capital expenditure need not correspond in amount to a penalty for the same amount of inefficient capital expenditure*".[58]

Transgrid also considered that applying CESS penalties in circumstances where the expenditure is prudent and efficient would be contrary to the following Revenue and Pricing Principle set out in section 7A(2) of the National Electricity Law (NEL), and the interests of consumers:[59]

> *"A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services".*[60]

We do not consider applying CESS penalties in circumstances where the expenditure is found to be prudent and efficient following an ex post review is contrary to clause 6A.6.5A(c)(2) [and 6.5.8(c)(2)] of the NER. This is because the CESS, and the ex post review performs different functions within the regulatory framework. The function of the CESS is to promote efficient investments by rewarding NSPs for efficiencies in capex (underspending their forecast) and penalising NSPs for inefficiencies in capex (overspending their forecast). The efficiencies and inefficiencies in capex refers to an NSP's performance against its ex ante forecast. The function of the ex post review is to determine whether the overspent capex should be added to the NSP's RAB. We do this by assessing the prudency and efficiency of the overspent capex against the capex criteria. The CESS and the ex post review complement each other. The CESS provides NSPs an ex ante incentive to beat their forecast, whereas the ex post review allows us to assess the prudency and efficiency of overspent capex, and whether the overspent amount should be recovered via regulated revenues.

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[56] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-6; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2; MLPL, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 9-12.

[57] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-6; MLPL, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025.

[58] NER cll. 6A.6.5A(c)(2) and 6.5.8(c)(2). We note that clause 6.5.8 refers to the distribution services - while the networks did not explicitly refer to this section, operations of the CESS on the distribution and transmission services is drafted similarly.

[59] Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 8.

[60] National Electricity Law ('NEL'), s 7A(2).

We also do not consider that applying CESS penalties to efficient capex overspend is contrary to the revenue and pricing principles set out in section 7A(2) of the NEL. This is because where the overspend capex is found to be efficient, following the ex post review, that capex is rolled into the opening RAB, meaning that it is recoverable in the forthcoming control period. While the imposition of CESS penalties may well mean that the NSP cannot recover all of its costs, this is a specific design feature of chapter 6 and 6A of the NER.

NSPs considered that if the CESS were to be applied to overspends, then it should only apply up to a specific cap, such as up to 10% of an overspend.[61] We do not agree with their proposed approach because it does not provide adequate ex ante incentives. We consider setting a cap on total overspend applicable to the CESS does not target the issues arising from forecasting uncertainties that we are seeking to address where it may be unreasonable to apply a CESS penalty. For example, significant changes that were beyond an NSP's control. Further, we do not consider it is reasonable to have a standardised cap for a portfolio of capex. This does not adequately take into account the specific issue of forecasting uncertainty that we are seeking to mitigate. Further, a cap such as 10% on overspends where the CESS applies does not provide reasonable continuous ex ante incentives to undertake efficient capex.

We also note that restricting the CESS in such a way for overspends would result in an unbalanced scheme where underspends is not subject to the same level of scrutiny and restrictions as we presume the underspends are in the long term interests of consumers. To better balance the scheme, underspends would also need to be reviewed. However, this would increase the regulatory burden and would not be consistent with the overall purpose of the ex ante regime as it would dilute forecast based incentives.

Our amendments to the Guidelines respond to the issues arising from forecasting uncertainties and other factors beyond NSPs control without significantly altering the incentive scheme which at the overall level remains fit for purpose. We consider the suggested approach by NSPs erodes ex ante incentives and do not adequately address issues arising from forecasting uncertainties.

5.4.3 Level of discretion to adjust CESS payments

NSPs did not agree that the AER should have broad discretion on determining whether it will reduce CESS penalties for efficient overspends following an ex post review. They considered that we should commit to making CESS adjustments because the lack of certainty will impact NSPs in making investment decisions.[62] NSPs also stated that if the regulatory pathway is

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[61] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 5; MLPL, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 9-12.

[62] ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 3; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-7; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 9-12; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 7; CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 3-6.

uncertain, NSPs will likely err on the side of caution and defer or avoid projects that are otherwise efficient.[63]

The EUAA also raised concern over the AER's discretion in allowing any modification of the CESS sharing ratio or exclusions as consumers require certainty as to the application of the CESS.[64] This is because it considered that CESS modifications remove the onus on the NSP to take all due care in managing a project to minimise an overspend.[65]

We acknowledge stakeholder concerns with our discretion to amend CESS payments following an ex post review. We introduced the discretion, to adjust the CESS, to target specific areas of uncertainty that cannot be addressed on an ex ante basis.

We will apply our discretion and adjust the CESS penalties using a set of specific factors, for TNSPs, and a type of connection for DNSPs, as defined in the Guidelines. Given the areas where we intend to apply discretion relate to newer areas of capex, it would be unreasonable for us to provide upfront certainty to NSPs on exclusions before we have undertaken an ex post review. We acknowledge this may create uncertainty for NSPs.

However, we also consider that a CESS that is prescriptive would require us to amend the CESS more regularly to take into account changes in an evolving market. This would also create uncertainty and unpredictability.

The introduction of discretion provides an avenue for NSPs to demonstrate that the additional capex is consistent with our factors as part of an ex post review. It provides us with flexibility to take into account information provided by NSPs on a case by case basis, and it also gives consumers an opportunity to engage and make submissions on relevant specific matters. Where previously, the NSP would have incurred a CESS penalty instead.

Similarly, we consider the modifications to the CESS does not remove the onus on the NSP to take care in managing its expenditure. Rather, where there are exceptional circumstances which results in an NSP needing to undertake material additional capex that could not be foreseen or managed by the NSP, the NSP will have to demonstrate why the capex should not be included in the CESS payment. Therefore, our approach does not weaken the CESS incentive but ensures that there is flexibility for us to promote efficient investments while protecting the long term interest of consumers.

Overall, our approach provides a middle ground between the NSP and the EUAA's submissions. Although this approach may increase regulatory burden in some instances, it also provides us and the NSPs the flexibility to respond to unanticipated new areas of capex. We consider that this discretion is targeted and will ensure that the CESS better reflects efficiency gains while still allowing the ex ante framework to be the primary framework in setting incentives to undertake efficient capex.

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63 ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 3.

64 EUAA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2.

65 EUAA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2.

5.5 Application of CESS and ex post review

We have applied the three considerations, discussed in section 5.4, in determining whether we should allow CESS exclusions and the manner in which we may apply any exclusions to DNSPs' and TNSPs' capex.

5.5.1 CESS exclusions for DNSP' capex

Ex ante CESS exclusions via volumetric adjustments for DNSPs business-as-usual connection capex

Several DNSPs submitted that the proposed CESS exclusion mechanism via volumetric adjustment may be impractical and complex and we should consider an ex ante exclusion for connections capex.[66] AusNet Services, however, supported volumetric adjustments for business-as-usual connection types, with the exception of embedded generation and some commercial and industrial connections such as data centres and electric vehicle charging stations.[67] AusNet Services considered that volumetric adjustments are suitable for the business-as-usual connections as the volume risk is likely to be greater than the unit rate risk, as the unit rates at sub-category level are well understood.[68] And even if unit rates, at sub-category level, do vary, the large volume enables network businesses to manage the risk.[69]

Non-network stakeholders broadly consider that CESS exclusions transfer project risk from the NSP, who are best placed to manage the project, to the consumers.[70] In particular, DEECA stated that excluding connections from the CESS may no longer incentivise DNSPs to plan and carry out works more efficiently. It considered that as the CESS is based on total capex, retaining the CESS incentive would mitigate the risk of overall overspend against a DNSPs' forecast.[71]

In balancing the stakeholder views, we are satisfied that our draft approach of applying volumetric adjustment provides sufficient flexibility in a time of significant connections uncertainty while retaining some oversight on connections expenditure. As per our draft Guidelines, we note that the volume of connections is an area where forecasting error, rather

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66 CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 1; Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-5; Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

67 AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3.

68 AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3

69 AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3

70 EUAA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2; Save Our Surrounding Riverina, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; DEECA, *Submission to the AER's Issues Paper on the draft proposals for each Victorian electricity DNSP for 2026-31 regulatory control period*, 3 June 2025, pp. 8-9 [49]-[52].

71 DEECA, *Submission to the AER's Issues Paper on the draft proposals for each Victorian electricity DNSP for 2026-31 regulatory control period*, 3 June 2025, pp. 8-9 [49]-[52].

than efficiency, is likely to drive the differences in capex outcomes, and that this can have a material effect on capex outcomes. This is because DNSPs must respond to connection requests and have little control over the volume of such requests. So, a volumetric adjustment to the CESS which takes into account the change in volumes of connections for each business-as-usual connection type, so that a DNSP is not rewarded or penalised for changes in the volume of work it needs to undertake, is appropriate. We consider this is a targeted way to the address the effect of forecasting error on the CESS, while retaining an incentive for DNSPs to undertake connections works efficiently.

Definition of business-as-usual connections and method for calculating volumetric adjustments

In our draft Guidelines we referred to 'business-as-usual' connection types as 'standard connections'. DNSPs have submitted that it is unclear which of their standard control services would meet the draft Guideline description, and that we should clarify whether we intended to apply the meaning of 'standard connections' under the NER.[72] AusNet Services, however, stated that network businesses should propose their own definition for these types of connections and, therefore, establish the scope of the volumetric adjustment mechanism that will be applied as part of its CESS calculation.[73]

For clarity we note that a volumetric adjustment mechanism is suitable for business-as-usual connections where there is historical data to accurately forecast the unit rates for each sub-category. We have defined business-as-usual connections to mean all common connection types where there is sufficient historical data, which includes all residential connections, commercial & industrial (except for bespoke large connections as defined below), subdivision and embedded network connection types. For these types of connections, DNSPs build their connections capex forecasts based on social and economic factors and there is sufficient historical data. So, DNSPs are able to forecast relevant net unit rates corresponding to each connection type based on historical data.

We consider volumetric adjustment for each business-as-usual connection is a simple and cost-effective mechanism to apply. The DNSPs are required to provide expenditure and volumes for each business-as-usual type of connection as part of their forecasts. The volumetric adjustment will be applied for each of these connection types by comparing the forecast to actual expenditure incurred. This mechanism is symmetrical, so that a DNSP is not rewarded or penalised for changes in the volume of work it needs to undertake. We do not envisage the DNSPs require any additional data than what is provided during a regulatory determination. So, we do not consider this approach introduces any significant burden.

We will apply volumetric adjustment as a default

In relation to the question as to whether the DNSPs should be able to opt-in to volumetric adjustments, we consider allowing such flexibility is in not in the best interest of the

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[72] Evoenergy, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[73] AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

consumers. All DNSPs submission have stated the forecasting uncertainties with connections capex, and this capex is not discretionary. So, applying volumetric adjustment is a symmetrical mechanism that reduces any windfall gains and losses associated with forecasting error in a time of significant connection uncertainty. By applying this mechanism as a default, it will ensure DNSPs are provided with a consistent incentive framework to business-as-usual connections. Efficiently, our approach removes forecast uncertainties caused by volatility in connection volumes.

Consistent with the propose-respond model, the DNSPs may propose to not apply a volumetric adjustment. We recognise that the regulatory framework is based on a total capex approach, and it is impractical to remove all forecasting uncertainties. So, if we are satisfied that there is less forecasting uncertainty for connection capex, it may be appropriate to not apply volumetric adjustment but rather apply the CESS on DNSP's total net capex. This will maintain a simple CESS mechanism that has been applied to date. However, given that volumes are beyond a DNSP's control; it should bear the onus to justify why it seeks to not apply the volumetric adjustments for business-as-usual capex. In adopting this approach, we consider that a DNSP should justify that any changes to connections capex forecast are immaterial to its total connection capex forecast.

For this reason, we will apply volumetric adjustments to all business-as-usual connection types as default. However, we retain the discretion to not apply volumetric adjustments proposed by the DNSP, or if there are overlaps with large bespoke connections as discussed below.

Ex post adjustments to the CESS penalties for DNSP's large bespoke connections capex

For DNSPs with large bespoke connections, we will maintain our draft Guidelines approach. In the draft Guidelines, we had proposed to allow ourselves the flexibility to adjust the CESS penalties after an ex post review for large bespoke connections that were not in a DNSPs original forecast. We consider that our approach will not limit DNSPs undertaking unforeseen capex for connecting consumers and any relevant network argumentation during the regulatory control period. This approach effectively introduces the ability for us to reduce the CESS penalty arising from these types of connections that have not been included in forecast capex. We would make any ex post adjustments to the CESS for large bespoke connections only after we have conducted an ex post review.[74]

The majority of DNSPs considered that we should exclude all connections capex from the CESS on an ex ante basis, as applying ex post adjustments in an event of an overspend complicates the CESS and is not symmetrical.[75] Further, DNSPs consider that the discretion

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[74] This means, the ex post adjustments to the CESS for large connections will only be done after we have undertaken an ex post review. We note there is a difference in timing between the regulatory control period and ex post review period. The ex post review period is the first 3 years of the relevant regulatory control period and the last 2 years of the regulatory control period preceding that.

[75] CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 1. Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-5; Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

over whether or not to allow for ex post adjustments adds to regulatory uncertainty.[76] Similarly, AusNet Services considered that we should consider ex ante exclusions for embedded generation and some commercial and industrial connections such as data centres and electric vehicle charging stations.[77]

Jemena submitted that based on the proposed drafting of the Guidelines, there could be a scenario where there is an ex post review but the CESS outcome is a small incentive payment not a penalty.[78] Ausgrid considered that there may be instances where DNSPs may receive a CESS reward from a particular project even if that project is funded entirely from consumer contributions.[79]

As above, we also consider it is important to maintain the structure of an ex ante incentive based regulatory framework. However, it is not the intention of the regime to ensure the network is made whole from forecast error. For this reason, we consider it is only necessary to intervene and reduce a portion of CESS penalties in an event where a DNSP is unfairly penalised for undertaking material additional connection capex, and associated augmentation works, that was not originally in their forecasts. So, the Guidelines provide that we may only reduce a DNSP's CESS penalties associated with large bespoke connections, including associated augmentation expenditure, to the extent that the expenditure exceeds the DNSP's total net capex forecast.

In relation to Jemena's concern, we note that it is possible that a DNSP may receive a CESS reward if an ex post review is triggered but this is due to the timing differences between regulatory period and ex post review period. In these instances, The CESS rewards would not be associated with the large bespoke connection capex. Our approach is targeted to specific large bespoke connection projects. We will only reduce CESS penalties to the extent necessary to ensure that DNSPs are not being unfairly penalised for undertaking additional large bespoke connections capex that was not in their forecast.

We also do not consider that volatility of customer contribution impacts the CESS assessment. In applying the CESS framework, we will determine what proportion of a total project expenditure is being funded by customer contributions. The CESS calculation removes the portion of customer contribution from the total capex and only calculates the CESS payments on the residual net capex amount.

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[76] CPU, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 1. Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-5; Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 3-4; Endeavour, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 3; Evoenergy, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 1.

[77] AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[78] Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 3-5.

[79] Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-5.

In relation to definition of large bespoke connection, we define large bespoke connection to mean large emerging connection types commercial and industrial connections, such as data centres, electric vehicle charging stations and grid connected batteries. Given the emerging nature of these types of connections, we do not intend to provide an exhaustive list. A DNSP has the opportunity to propose other large bespoke connections in its proposal. In response to the DNSP's proposal, we will then determine whether or not to adjust the CESS penalties, following an ex post review for the proposed large bespoke connection and the associated augmentation expenditure.

Uncertainty about the difference between business-as-usual connection and large bespoke connection

DNSPs have submitted that there is a lack of clarity between the definitions of business-as-usual connection and large bespoke connection, and that the AER should define all connection types.[80] AusNet Services considered there should be flexibility for a network business to propose its own definition because some business-as-usual connection types may overlap with large bespoke connections.[81] For example, it considered that commercial and industrial connections relating to business supply projects is a business-as-usual connection type and suitable for volumetric adjustment. But even though data centres connections are commercial and industrial connections, it considered that these are not suitable for volumetric adjustment.[82]

We agree that in some circumstances, there may be an overlap between a business-as-usual connection and a large bespoke connection. However, given the emerging nature of new connection types and the forecasting uncertainties, we consider it is appropriate to be less prescriptive in the Guidelines.

For this reason, in our regulatory determination we will assess whether large bespoke connections should be excluded from the volumetric adjustment mechanism, in response to a DNSP's proposal on a case-by-case basis. To do this we will have regard to a DNSP's justification as to why a certain connection category, or sub-category, should be excluded from a volumetric adjustment mechanism. This approach allows flexibility to account for forecasting uncertainty with emerging connection types on a case-by-case basis.

Broader CESS exclusions for DNSPs' capex

Some DNSPs submitted that we should consider broader ex ante exclusions for other capex categories such as resilience.[83] We consider it is important to retain an ex ante incentive

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[80] Evoenergy, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Jemena, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[81] AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[82] AusNet Services, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2.

[83] SAPN, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 3.

based regulatory framework. We provide a DNSP with a total capex forecast that reflects the prudent and efficient costs of managing a safe, reliable, and secure network and meetings its regulatory obligations. DNSPs have the flexibility to manage and prioritise their capex portfolio during the regulatory control period, having regard to new information.

Energy Queensland have also suggested we should provide ex post exclusions for overspends related to material prices in the international markets, severe weather or changes in government legislation and policies.[84] The pass-throughs, contingent projects and re-openers provisions under the NER have been formulated to address specific risks under the regulatory regime, consistent with meeting the National Energy Objective. While these provisions provide a mechanism for NSPs to revise capex forecasts upwards, these additional expenditures are subject to a materiality threshold and certain conditions being met. We consider any amount below the materiality threshold, will be immaterial to pass on the risk to consumers. Therefore, we do not consider any changes to the CESS is required address these issues.

As noted in our draft Guidelines, some DNSPs considered that capex projects supported by consumers should be excluded from the CESS on a 'use it or lose it' basis.[85] We maintain our position that a DNSP can choose to not recover a portion of its CESS reward, so a 'use it or lose it' type of arrangement can be implemented without needing exclusions from the CESS. Thus, it may not be reasonable to exclude 'use it or lose it' projects from the CESS entirely as this will reduce the incentive to undertake these projects efficiently if they go ahead. In recognising the need for clarity, we have amended section 2.3.4 of the final Guidelines (version 4). We have expressly stated that an NSP may propose to vary its CESS reward (or penalty) to voluntarily reduce its CESS reward (or increase its CESS penalty) as this may directly benefit consumers.

5.5.2 CESS exclusions for TNSPs' non ISP project capex

We have broadly maintained our approach proposed from the draft Guidelines. In the draft Guidelines we proposed an ex post CESS adjustment that accounts for unforeseen projects and reflects an overall increase in the scope of works a TNSP undertakes during a regulatory control period. We consider that this situation could give rise to CESS penalties that may not reflect efficiency gains or losses, are beyond the control of the TNSP, and that may have a material impact on the capex outcomes for the TNSP.

We may apply an ex post CESS adjustment where there is an efficient increase in an TNSP's scope of works, and the incurred capex is not accounted for in a contingent project application, cost pass through application or a reopener. We would make any ex post adjustments to the CESS only after we have conducted an ex post review.[86]

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[84] Energy Queensland, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 3.

[85] AER, *Capital Expenditure Incentive Guidelines Review 2025 – Explanatory Statement for Draft Guidelines,* 16 May 2025, p. 21.

[86] This means, the ex post adjustments to the CESS will only be done after we have undertaken an ex post review. We note the difference time between the regulatory control period and ex post review period. The ex post review period is the first 3 years of the relevant regulatory control period and the last 2 years of the regulatory control period preceding that.

Our assessment would identify whether any overspend was a result of a TNSP undertaking additional projects that were not accounted for in the capex forecast at the time of the AER's final determination. The TNSP would need to demonstrate that it could not reprioritise its projects and that there was an increase in the overall amount volume of work it had to do. If we are satisfied that there was a material overall increase in work, then we would not apply a CESS penalty to the additional projects.

The TNSP would still be subject to a CESS penalty where there are increases in the costs of projects that were included in forecast capex, as these cost increases do not reflect an increase in the scope of works the TNSP had to undertake. We also note our ex post review is not limited to specific categories or projects were NSPs overspend. We may assess all cost categories or projects to be satisfied if there is a genuine increase in TNSP's scope. This ensures that ex ante incentives would still apply to capex that is not a driver of the overspend. We have included the following factors we will take into account in determining whether there has been a change in scope:

- whether the proposed adjustments relate to projects that were not in included in the TNSP's current period forecast
- our findings in the relevant ex post review period
- whether the TNSP has demonstrated it has reasonably managed and prioritised its total capex
- the degree to which the overspend was due to factors beyond the TNSP's control
- other relevant factors.

We would only consider allowing ex post exclusions in limited circumstances and would only make an ex post adjustment to the CESS after an ex post review.

TNSPs considered that if expenditure is found to be prudent and efficient following an ex post review, we should not penalise NSPs under the CESS framework.[87] TNSPs also did not support the extent of the AER's discretion in deciding whether to adjust CESS penalties following an ex post review.[88] TNSPs considered that we should provide further certainty as TNSPs should not be penalised for the increases that are beyond their control, whether the causes of that increase relate to scope changes, input costs or other factors.[89]

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87 ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-6; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2; MLPL, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 9-12.

88 Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 9; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 6.

89 Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 9; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 6.

As above, we consider that the operations of CESS and the ex post review is in alignment with the NER. Similar to our assessment during a regulatory determination, the AER will need to assess whether the overspent amount genuinely relates to scope change due to factors beyond a TNSPs control on a case-by-case basis. So, we have provided a set of factors we will have regard to in determining whether we should reduce CESS penalties in each instance. This approach will allow better flexibility and transparency as stakeholders can provide a specific submission based on the circumstances of the case. We also consider that automatically removing the CESS penalty following an ex post review would not provide sufficient ex ante incentives.

However, in recognising the need for further certainty and clarity, we have made a minor amendment to the factors we will have regard to in deciding whether we will reduce CESS penalties for a TNSPs' non-ISP capex. Specifically, we have replaced the factor "*a comparison of the projects undertaken against projects forecasted for the relevant regulatory determination*" with "*whether the proposed adjustments relate to projects that were not included in a TNSP's forecast*". The updated factor provides clarity on the scope of projects where we may consider reducing CESS penalties.

5.5.3 CESS exclusions for TNSPs reviewable ISP project capex

We acknowledge that for an actionable ISP project, or a stage of an actionable ISP project, there are elements of capex that may be harder to forecast than non-ISP capex. Given the size of large individual projects, there may be a limited ability for networks to reprioritise their capex.

Our existing Guidelines (version 3) already take into account forecasting uncertainties for actionable ISP project, or a stage of an actionable ISP project. The Guidelines (version 3) provide us with flexibility to allow exclusions or modify the CESS on an ex ante basis. In addition, we may include a project risk allowance in a contingent project determination for an actionable ISP project, or a stage of an actionable ISP project. Our guidance note on the regulation of actionable ISP projects sets out our assessment approach and expectations on the supporting information accompanying a contingent project application.[90]

Overall, we consider our existing ex ante exclusion mechanism is fit for purpose. However, we recognise that there may be instances where the CESS framework applied during the determination may not fully respond to significant forecasting uncertainties beyond an NSP's control.

The current Guidelines (version 3) do not include the ability to adjust the CESS payments on an ex post basis. We consider adding this flexibility will ensure that the CESS remains fit for purpose.[91] However, we consider that this ex post adjustment should be limited to where the overspend is genuinely beyond a network's control and based on unforeseeable factors. In making any adjustment, the AER would have regard to the following factors:

- the form of CESS in place for the relevant project
- our findings in the relevant ex post review period

[90] AER, *Guidance note - Regulation of actionable ISP projects*, March 2021.

[91] We would make any ex post adjustments to the CESS only after we have conducted an ex post review.

- whether the TNSP has demonstrated it has reasonably managed and prioritised its total ISP project capex
- the degree to which the overspend was due to factors beyond the TNSP's control
- other relevant factors.

TNSPs considered that if expenditure is found to be prudent and efficient following an ex post review, we should not penalise NSPs under the CESS framework.[92] TNSPs also did not support the extent of the AER discretion in in deciding whether to adjust CESS penalties following an ex post review.[93]

For the same reasons provided in section 5.4, we consider that this approach balances the need to have effective ex ante incentives for NSPs to pursue efficiencies and appropriately manage risk while recognising that there may be instances where it may be unreasonable or unfair to apply a CESS penalty for overspends.

[92] ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 4-6; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 1-2; MLPL, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 9-12.

[93] Powerlink, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 2; ElectraNet, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 2-3; Transgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 9; ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 6.

6 Interaction with CESS and efficient abandonment

6.1 Issue

In its submission to the AEMC's bringing forward early works to improve transmission planning rule change (early works rule change), the Clean Energy Finance Corporation (CEFC) raised concerns about the risk of consumers bearing the cost of procuring early works assets where the project no longer needs them or is cancelled.[94]

For this reason, in our draft Guidelines, we introduced a mechanism to allow the AER flexibility to adjust CESS rewards. We proposed to explicitly state that we can remove any CESS rewards for an event where an ISP project is abandoned.

6.2 Amendments and reasons for our positions

Changes from the draft Guidelines

- There have been no changes from the draft Guidelines to this issue.

The amendment to our Guidelines gives the AER the flexibility to adjust the application of CESS for ISP projects that are abandoned. In practice, this is a CESS exclusion that would be applied after an ISP project is reported to be abandoned.

To allow us this flexibility, we introduced a new sub-section for *CESS adjustments for abandoned ISP projects*. This sub-section gives the AER flexibility to adjust CESS rewards and penalties. We explicitly state that we may remove any CESS rewards for an event where an ISP project is abandoned - please see section 2.8.3 of the final Guidelines (version 4).

We have maintained our position from the draft Guidelines. Our amendment to the Guidelines applies to all ISP projects that have been reported to be abandoned, at any stage of the project. Our amendments give us the flexibility to adjust an NSP's CESS for any ISP projects in order to exclude allowable capex for abandoned ISP projects.

Ausgrid submitted that we should develop clear criteria when a decision to abandon a project is deemed efficient, to provide regulatory certainty.[95] We consider that this matter is outside the scope of this review. That said, we note that the matter of efficient abandonment will be an investment decision proposed by relevant NSPs. Therefore, consistent with the propose-respond model, we will only adjust the NSP's CESS rewards based on its proposal to abandon an ISP project.

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[94] AEMC, *National Electricity Amendment (Bringing early works forward to improve transmission planning*) *Rule 2024,* 5 September 2024.

[95] Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, pp. 6-7.

7 Other matters

7.1 Changes to accommodate the transitional provision

Changes from the draft Guidelines

- There have been no changes from the draft Guidelines to this issue.

In our draft Guidelines, we had regard to the AEMC rule change which introduced a new transitional provision allowing us to make a revenue adjustment to increase the maximum allowed revenue in the next period by an amount equivalent to (or less than) the penalties applied, or will be applied, under a CESS in relation to an ISP project already subject to a CESS. [96] This includes Project Energy Connect (PEC), HumeLink and VNI-West.[97] Effectively, the transitional provision allows us to make future revenue adjustments to offset any CESS penalties following an ex post review for ISP projects.

For clarity, the new transitional clause set out in the NER is limited to ISP projects and does not extend to non-ISP projects.

We have maintained our draft Guidelines approach. In our draft Guidelines we proposed to allow ourselves the flexibility to reduce CESS penalties following an ex post review for reviewable ISP projects that are already subject to a CESS at the time of release of a version of our Guidelines (version 4). In deciding whether to exercise this flexibility, it will be determined on a case by case basis using the factors set out above for reviewable ISP projects. Please see section 2.8.3 and 2.8.4 of the final Guidelines (version 4).

ENA considered that the final Guidelines (version 4), including the changes to the CESS exclusions, should apply to all DNSPs and TNSPs retrospectively.[98]

We do not consider this is a valid option. The NER sets out *constituent decisions* we are required to make as part of the draft and final distribution and transmission determinations.[99] In particular, as per NER clauses 6.12.1(i) and 6A.14.1(5A), we are required to make a decision on how any applicable CESS is to apply to DNSPs and TNSPs as part of a distribution and transmission determinations respectively. Therefore, the nature and details of the CESS that is applicable to the relevant regulatory control period is decided at the time of the making our revenue determination on a forecast basis. We cannot modify the application of the CESS retrospectively. For this reason, the amendments made to these Guidelines can only be applied for any future determination we make.

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96 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination,* 01 August 2024, p. 20; NER, cl. 11.172.3.

97 AEMC, *National Electricity Amendment (Managing ISP project uncertainty through targeted ex post reviews) Rule 2024: Final Rule Determination,* 01 August 2024, p. 20.

98 ENA, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 9.

99 NER cll. 6.12.1 and 6A.14.1.

7.2 CESS Exclusions for REZ and single asset RAB

Changes from the draft Guidelines

- We have minor clarifications to our final Guidelines (version 4) to improve clarity, but these changes from our draft Guidelines do not otherwise alter the requirements or considerations.

As mentioned above, section 2.6 of the current Guidelines (version 3) provides flexibility to allow exclusions or prescribe any form of CESS on an ex ante basis for large transmission projects.

We note that the CESS also has a role in our REZ determinations, such as NSW REZ non-contestable revenue determinations made under the *Electricity Infrastructure Investment Act 2020 (NSW)* (EII Act).

We have clarified our position from the draft Guidelines. In the draft Guidelines, we considered that NSW REZ non-contestable projects may face forecasting risks similar to transmission contingent projects. In the final Guidelines, we have clarified that we have the flexibility to modify the application of the CESS to any relevant REZ determinations, including but not limited to NSW REZ non-contestable determinations or where we are required to make decision about the application of the CESS under any other legislation. [100]

Similarly, a business with a single asset in its RAB might also face similar forecasting risks and a limited ability to manage and reprioritise its total capex forecast. We have maintained our draft Guidelines position that the flexibility to modify the application of the CESS may be extended to a business with a single asset in its RAB as well.

Ausgrid submitted that the AER should extend the same regulatory flexibility and risk management tools proposed for TNSP led REZ projects to DNSP-led projects of comparable scale, risk, and uncertainty.[101] When proposing the changes in our draft Guidelines, we did intend the flexibility to apply to any NSP undertaking REZ projects, including but not limited to NSW REZ non-contestable projects, or a business with a single asset in its RAB. We have updated the final Guidelines (version 4) to clarify this. Please see sections 2.6.2 and 2.8.3 of the final Guidelines (version 4).

[100] We also consider there are differences between the NER and relevant REZ jurisdictional frameworks such as the EII Act. So, there may be additional factors to consider on a case-by-case basis for REZ projects. For instance, NSW REZ non-contestable projects may have additional considerations that are specific to the EII framework, such as several adjustment mechanisms (not included in the NER) which could help the business manage its cost variation risk.

[101] Ausgrid, *Submission to the AER's Capital Expenditure Incentive Guideline Review – Draft Guidelines,* 27 June 2025, p. 6.

Glossary

Term	Definition
AER	Australian Energy Regulator
AEMC	Australian Energy Market Commission
Augex	Augmentation expenditure
Capex	Capital expenditure
CEFC	Clean Energy Finance Corporation
CESS	Capital Expenditure Sharing Scheme
DEECA	Victorian Department of Energy, Environment and Climate Action
DNSP	Distribution network service provider
ENA	Energy Networks Australia
EUAA	Energy Users Association of Australia
Guidelines	Capital Expenditure Incentive Guidelines
ICT	Information and Communications Technology
ISP	Integrated system plan
ISP review period	Has the meaning prescribed in S6A.2.2A(a1) of the National Electricity Rules.
JEC	Justice and Equity Centre
NER	The National Electricity Rules as defined in the National Electricity Law.
NSP	Network service provider
Opex	Operating Expenditure
PEC	Project EnergyConnect
RAB	Regulatory asset base
Reviewable ISP project	Has the meaning prescribed in S6A.2.2A(a1) of the National Electricity Rules
Reviewable ISP project stage	Reviewable ISP project stage includes any predefined stage of a reviewable ISP project other than early works stage.
REZ	Renewable energy zone
TNSP	Transmission network service provider

Appendix A – Illustrative examples

Volumetric adjustments for DNSPs

Volumetric adjustment to the CESS takes into account the change in volumes of connections, for each business-as-usual connection type, so that a DNSP is not rewarded or penalised for changes in the volume of work it needs to undertake.

Assume that an NSP's forecast volumes and unit rates and its actual volumes for its "Residential Simple connection LV" capex are as shown in Table 3 below. The table also shows the change in volume and the resulting volume adjustment under two different scenarios.

First, we compare a change in volume by subtracting the actual volume from the forecast volume for each specific business-as-usual connection type. Then, we calculate the volumetric adjustment by multiplying the change in volume by the forecast unit rate that was deemed to be efficient in the revenue determination for relevant regulatory period.

Table 2: Volumetric adjustment scenarios

Description	Scenario 1	Scenario 2
Forecast volume	400	500
Forecast unit rate ($ million per connection)[102]	0.25	0.25
Actual volume	600	200
Change in volume	200	-300
Volumetric adjustment formula	= (200*0.25)	= (-300*0.25)
Volumetric adjustment ($ million)	50	-75

In scenario 1, the calculated volumetric adjustment is positive $50 million for Residential Simple connection LV. This is the amount that will be excluded from the actual capex when calculating the CESS payments.

In scenario 2, the calculated volumetric adjustment is negative $75 million Residential Simple connection LV. This amount will be included in the actual capex, to correct for the reduced volumes delivered.

We will apply the above volumetric adjustment mechanism for each of the business-as-usual connection type (see RIN category). This approach will ensure that forecast unit rates are representative of each connection type.

[102] For simplicity, please assume the forecast unit rates are presented in $ real dollars for the relevant regulatory control period. In practice, we will need to adjust the unit rates to correct $ real terms.

Reducing of CESS penalties for DNSP's large connections capex following an ex post review

For large bespoke connection we allow ourselves the flexibility to adjust the CESS penalties after an ex post review that was not in DNSPs original forecast. This mechanism provides DNSPs the flexibility to recover efficient expenditure for large bespoke connection that was not originally in its forecast.

Please note the following assumptions and the scenario provide in Table 3:

- DNSP proposes data centres as a large bespoke connection type for its upcoming determination
- In undertaking its capex program, DNSP was required to connect a new data centre that was not in its forecast capex and incurred an additional $200 million.
- The additional expenditure is found to be efficient in an ex post review

Table 3: Illustration of application of ex post adjustments for large bespoke connection ($ million)

Description	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Forecast Capex	-	-	-	-
Gross Capex Forecast	800	800	800	800
Net Capex Forecast	600	600	600	600
Actual Capex	-	-	-	-
Gross Capex Actual incurred	1000	1000	1000	1000
Net Actual Capex incurred	620	500	700	610
Additional bespoke connection Gross Capex	200	200	200	200
Additional bespoke connection Net Capex	20	20	20	20
Calculations	-	-	-	-
Is ex post review triggered?	Yes	Yes	Yes	Yes
Net Capex Underspend	-20	100	-100	-10
CESS incentive/ penalty[103]	-6	30	-30	-3
CESS reduction following ex post review	6	0	6	3
Adjusted CESS outcomes	0	30	-24	0

[103] For simplicity the calculation uses the standard 30% sharing ratio and does not account for any financing benefit. In practice, the values may difference considering the financing benefit or costs and the net present value of the expenditure.

In scenario 1, we may reduce the DNSP's CESS penalty by $6 million to ensure it is not unfairly penalised for undertaken additional connection capex. In this scenario, we are satisfied that DNSP would not have incurred $20 million overspend, and $6 million CESS, penalty *but for* the new data centre that was not in its original forecast. For this reason, we may exercise our discretion to adjust the DNSP's CESS penalty.

In scenario 2, we are satisfied that the DNSP managed its total net capex forecast. It is important to maintain the ex ante forecast regime. Thus, we will not make any CESS adjustments in this scenario.

In scenario 3, we may reduce the DNSP's CESS penalty by $6 million to ensure it is not unfairly penalised for undertaken additional connection capex. In this scenario, we are not satisfied that $100 million overspend, and $30 million CESS penalty, relates to large bespoke connection. Instead, we consider only $20 million of the overspend, or $6 million in CESS penalty, is associated with the new data centre. For this reason, we may adjust the DNSP's CESS penalty, in so far as it relates to the large bespoke connection.

In scenario 4, we may reduce the DNSP's CESS penalty by $3 million to ensure it is not unfairly penalised for undertaken additional connection capex. In this scenario, while the net capex of the additional data centre was $20 million, it only incurred a $10 million overspend. So, we are satisfied that DNSP would not have incurred $10 million overspend, and $3 million CESS, penalty *but for* the new data centre that was not in its original forecast. For this reason, we may adjust the DNSP's CESS penalty.